FINANCIAL ADVISORS, HIDDEN FEES, INCENTIVES & STANDARDS

The Forces Driving Investment Advice

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Financial Advisors, Hidden Fees, Incentives & Standards

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It is difficult to overstate the impact financial decisions have on all aspects of a person's life. The outcomes of these decisions dictate retirement lifestyle, educational opportunities for children, access to better medical options and a greater ability to pursue philanthropic endeavors and personal hobbies (to name a few). Psychological effects, including stress, sense of accomplishment and peace-of-mind, while difficult to quantify can clearly be affected by changes in personal financial stability.

These are just some of the reasons that drive investors to seek professionals to guide them through important financial decisions.

Difficulties in Selecting the Right Financial Advisor

Unfortunately, the decision to hire ***a*** financial advisor is usually much easier than the process of selecting ***the right*** advisor. For many, the importance of selecting the right advisor is matched by suspicion and confusion - and understandably so. The sheer number of types of advisors, titles, designations and terminology can confuse even the most financially-literate. Anyone can claim to be a "financial advisor" – literally – as no legal statute prevents the self-anointment of this title. Further complicating matters, different types of financial advisors operate under different legal environments and within different business models. These differences, nuanced as some are, profoundly impact how advisors manage client assets, which in turn, impacts a client's likelihood of reaching important financial goals.

Understandably, investors generally want to meet face-to-face with prospective advisor(s) before entrusting the wealth and financial well-being of themselves and loved ones. In this vetting process, how does the investor know the right questions to ask? Could the investor identify potential conflicts of interest or detect deception?

Financial advisors know their own industry better than do their clients. The informational advantage enables advisors to play-the-system to their benefit, usually to the detriment of clients.

What Many Investors Don't Know – But Should

The good news: this informational gap can be erased. Investors need not sift through thousands of articles covering thousands of topics, but instead, focus only on a handful of issues that are the true driving forces influencing investment advice. These topics, detailed in later sections, include:

- **Primary Types of Financial Advisors**
- **Suitability Standard vs. Fiduciary Standard**
- **Transparency Requirements**
- **Advisor Compensation Arrangements**
  - *Fee-Based*
  - *Commission-Based*
- **Statistics & Studies**

Familiarization of these topics equips an investor with the information needed to conduct a proper search that is likely to match with an advisor that is truly incentivized to act in the best interest of clients.

Primary Types of Financial Advisors

Professionals rendering investment advice can be broadly categorized as either (1) a registered investment adviser (RIA) or (2) a broker:

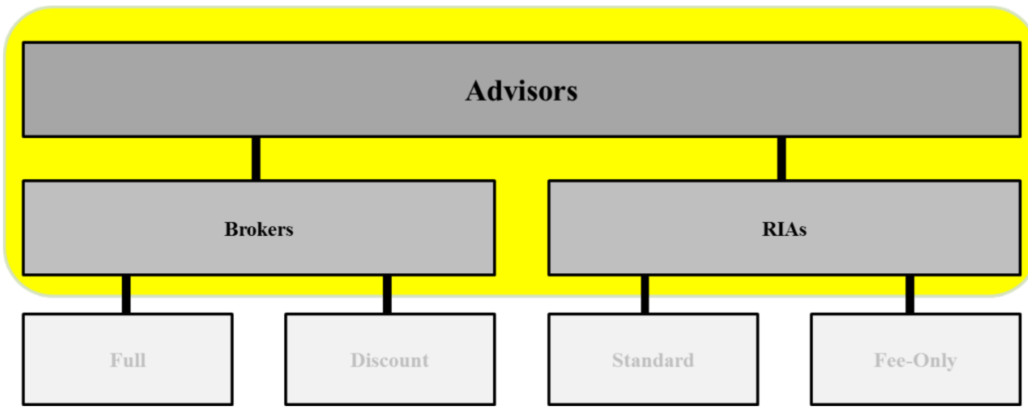
1. RIAs abide by the Investment Advisers Act of 1940, which dictates that RIAs must always act in the *best* interests of clients. This edict is referred to as a ***fiduciary*** *standard*. RIAs generally provide comprehensive financial planning to clients. RIA compensation is typically fee-based.

2. Brokers are regulated by the Financial Industry Regulatory Authority (FINRA) and adhere to a ***suitability*** standard. Brokers are allowed to provide advice that is incidental to the product(s) sold. Broker compensation has historically been derived from sales commissions, though a 1999 SEC ruling allows brokers to offer fee-based products as well.

Fundamental Differences between RIAs and Brokers			
Type	**Standard**	**Compensation Model**	**Scope of Advice**
RIAs	Fiduciary	Fee-Based	Comprehensive
Brokers	Suitability	Transaction and Fee-Based	Product-Specific

Titles & Terminology Clarification

The term “advisor” is broadest in scope, referring to any professional compensated for providing advice and/or selling investment products – including RIAs and brokers. The terms “RIA” and “broker” are broad in scope; each can be subdivided into different types.



For clarity, throughout the paper different types of RIAs or brokers are distinguished only if such distinctions relate to the incentive structures influencing the advisor/client relationship and advice rendered.

Suitability vs. Fiduciary Standard

An investor can bypass much the jargon, confusion and misleading statements by asking one simple question: Does the advisor adhere to a ***suitability*** standard or ***fiduciary*** standard?

The difference between the two standards is profound. The fiduciary standard demands advisors to do ***what is best*** for clients, whereas the suitability standard holds advisors to do ***what is appropriate*** for clients. The vagueness of “what is appropriate” creates a grey area that incentivizes advisors to ***not*** act in the best interest of clients. As an end result of this standard, clients are typically charged higher-than-necessary fees.

Suitability Standard Overview

As previously noted, under a suitability standard, a financial advisor is required to make a recommendation that is appropriate to the client. The SEC clarifies the standards definition[1]:

> "When your broker recommends that you buy or sell a particular security, your broker must have a ***reasonable basis*** (emphasis mine) for believing that the recommendation is suitable for you."

For example, a broker would have a "reasonable basis" in recommending a mutual fund emphasizing highly-rated and income-generating investments to a mid-70s conservative retired couple. If one fund paid to the broker a 6 percent commission and a similar fund paid to the broker a 2 percent commission – which fund is the broker more likely to recommend? Although both recommendations are supported by ***reasonable basis***, the higher-commission choice that is clearly in the best interest of the broker is just as clearly ***not*** in the best interest of the client. The suitability standard allows for misaligned incentives.

Fiduciary Standard Overview

Under a fiduciary standard, a financial advisor is required to act in the ***best*** interest of the client[2]. The SEC publication *Information for Newly-Registered Investment Advisors*[3] explicitly states:

> "As a registered investment adviser, you are a 'fiduciary' to your advisory clients. This means that you have a fundamental obligation to act in the ***best*** (emphasis mine) interests of your clients and to provide investment advice in your clients' ***best*** (emphasis mine) interests."

Continuing with the above example, a recommendation including ***any*** sales commission on a bond fund would not be in the ***best*** interest of the aforementioned mid-70s conservative retired couple, let alone a fund charging a 6 percent commission. Such a recommendation is not consistent with a fiduciary level of care.

The difference between the suitability and fiduciary standards profoundly affects how your investments are managed. The suitability standard leads to not only obvious conflict-of-interest issues with the level of commissions charged, but also transparency problems.

On paper, the level-of-care and duty to clients implored by the fiduciary standard is clearly superior to that described by the suitability standard.

What really matters to investors is to what extent advisors ***actually adhere*** to these standards. After all, "what is best," though less subjective than "suitable," is still subjective.

Standards – From Ideas to Practice

From the ***Enron Code of Ethics*** (Published July 1, 2000), page 4:

> "We believe in respect for the rights of all individuals and are committed to promoting an environment characterized by dignity and mutual respect for employees, customers, contractors, suppliers, partners, community members and representatives of all levels of Government."

What good are standards if they are ignored? It is one thing for an advisor to ***say*** decisions are made in clients' best interest, and entirely another thing for an advisor to ***actually make decisions*** in the clients' best interest. It probably is not wise to expect, or even hope, advisors to adhere to high ethical standards simply because it is written somewhere in an ethos statement.

The best way to assure advisors adhere to the fiduciary standard is to create incentive structures such that the interests of advisors and clients align. The two primary incentive structures aligning RIA and client interests are:

1. Compensation arrangements, and
2. Transparency requirements

Compensation Arrangements

Fee-based and transaction-based are the two predominant compensation structures for advisors.

A ***fee-based model*** is straight-forward. An advisor may charge a 1.5% annual fee. This fee, established contractually between the advisor and client, is independent of the advice rendered or securities traded. Advisors operating within this model receive a percentage of total assets under management. The better the accounts perform, the greater the compensation the advisor receives (and vice-versa).

A tangential note on advisor fees: At of the time of this writing, investors may be able to deduct advisor fees for tax purposes[4]. In some circumstances, individuals are permitted to deduct these fees as "miscellaneous itemized deductions" for amounts exceeding 2% of the filer's AGI. An investor's subjectivity to the alternative minimum tax influences the ability to deduct these fees. CPA consultation regarding fee deductibility is advised.

A ***transaction-based model***, in its pure form, is also straight forward. Brokers receive commissions for buying and/or selling a particular security. This model incentivizes brokers to trade frequently. The amount of the commission usually depends on the security itself. Commissions can be priced as either a fixed amount or percentage of security value. This model does not align client investment performance with broker compensation.

In other words, trading frequency – not performance – drives broker compensation.

From a client's perspective, the annual fee (fee-based model) or sales commission (transaction-based model) are in-addition-to any underlying expenses resulting from the securities themselves. For example, assume the fee-based advisor charging 1.5% invests all of a client's assets into a single mutual fund. That fund, independent of the advisor, charges its own fee. If the fund's annual expense is 2%, the total annual cost to the client is 3.5 percent.

The problem is ***not*** the mere existence of fund expenses. Rather, real problem is the misaligned incentives arising from the complex fee-sharing arrangements between advisors and the investment fund which they recommend.

A Deeper Look into Fund Expenses & Revenue Sharing Arrangements

Mutual funds are the predominant investment vehicle preference amongst many advisors, and hence are used to illustrate the aforementioned fee-sharing arrangements. Note, however, that mutual funds are not the only type of investment vehicle with these types of arrangements.

Mutual fund fees typically fall within one of two categories: operating expenses and sales commissions. Within each basic type of fees are several sub-types of fees. The varying sub-types of fees – all with varying levels of transparency – can be a source of confusion for investors. Note that ***all*** funds have operating expenses, but only ***some*** funds have sales commissions.

Operating Expenses – Expense Ratio

Just like any business, mutual funds incur operating costs. These costs are encapsulated in the fund's expense ratio, which is expressed as a percentage of total investment. For example, a client investing $100,000 into a fund with a 1.6% expense ratio will have, over the course of one year, $1,600 siphoned from the investment to pay for expenses such as printer ink, property taxes and computer software. The expense ratio is comprised of three subtypes of fees: advisory[1], administrative and 12b-1.

Expense Ratio Fee Subtypes	
Name	**Description**
Advisory Fee	Direct payment to the fund's manager(s)
Administrative Fee	Customer service, mailings, record-keeping, etc.
12b-1 Fee	Cost of marketing, sales and distribution

The 12b-1 fees are controversial – as these are the fees paid from funds directly to the advisors who recommend them. Total 12b-1 payments to brokers reached $9.5 billion in 2009. These payments are not particularly transparent – as brokerage clients simply do not have a practical way to discover where their 12b-1 fees end up.

Sales Commissions

All mutual funds can be classified as either load (sales charges) or no-load (no sales charges). For loaded funds, the sales charges come in three classes: A, B and C.

Class-A shares, sometimes referred to as front-loaded shares, are the most straight-forward of the three share classes. The load charge (i.e. sales commission) is assessed immediately. For example, an investor placing $100,000 into a Class-A share mutual fund charging 4% will immediately see the balance drop to $96,000. The immediate decrease in principle is an obvious downside, however; Class-A shares have lower annual expenses than do Class-B and Class-C shares.

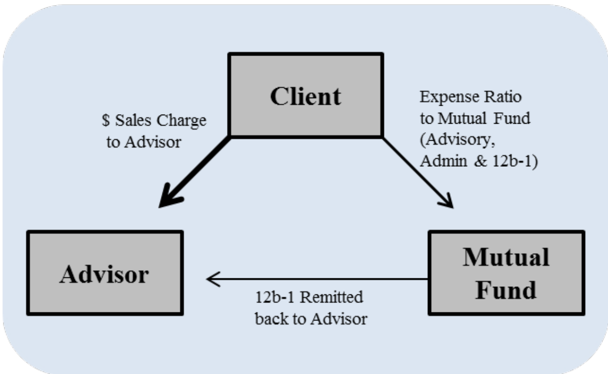
Class-B shares, sometimes referred to as back-loaded shares, are the most complex of the three share classes. No up-front sales charge is assessed in Class-B shares. However, these charges are "offset" by increasing the expense ratio of the Class-B share for a pre-determined number of years. Typically, the total increase in 12b-1 fees approximately equals the "decrease" of the front-end load charge.

Investors selling out of the fund prior to expiration of the lock-in period are assessed a ***redemption charge*** (Note: the terms *redemption charge* and *back-end sales charge* can be used interchangeably). Redemption charges are typically calculated on a regressive schedule – the longer an investor holds the Class-B share, the lower the penalty. After the lock-in period expires, the Class-B share converts to a Class-A share. Typically, the lock-in schedule is constructed such that the total increase in 12b-1 fees approximately equals the "decrease" of the front-end load charge. The length of most lock-in periods

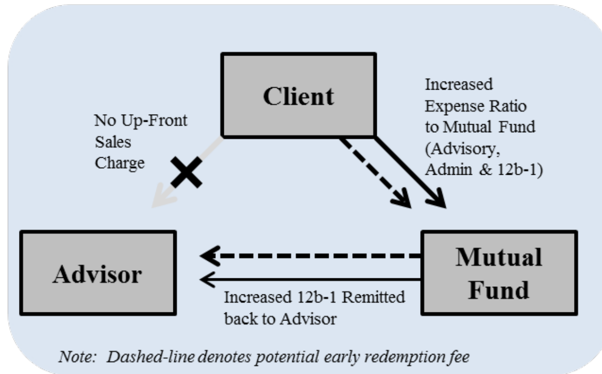
[1] Adding to the confusion, ***Advisory Fee*** in this context refers to the mutual fund manager compensation. The parlance of finance is contextual, with terms having multiple meanings.

falls within a broad range of 2-7 years, whereas the amount of most redemption charges falls within a range of 3-6 percent.

Class-A Fee Structure



Class-B Fee Structure



A tangential note on returns: the performance of Class-A shares and Class-B shares will vary slightly – depending on the market performance subsequent to fund purchase and the exact terms (lock-in length and expense ratio increase) of the Class-B share. However, these differences are typically small. To generalize, Class-B shares typically offer no advantage over Class-A shares and come with less fee transparency.

Class-C Shares, sometimes referred to as level-load shares, have neither front-end nor back-end sales charges. Instead, the sales charge is re-assessed as a 12b-1 charge, increasing expense ratios (compared to Class-A shares). Over a long-term time horizon, Class-C Shares underperform Class-A shares, as the return erosion caused by higher expense ratios becomes more pronounced over time. Within a shorter time horizon (roughly – two years or less), Class-C shares are a better choice than Class-A, as a large one-time sales charge is averted.

The table below summarizes the main characteristics of the three classes. The asterisks reiterate that performance differences arise because of the exact terms of the redemption schedules, 12b-1 increases (the details of which are set by the fund company).

Share Class Comparison for Load Mutual Funds				
Class	**Load Type**	**Transparency**	**Short-Term***	**Long-Term***
Class A	Front-End	High	Most Expensive*	Least Expensive
Class B	Back-End	Low	Most Expensive*	Schedule-Specific
Class C	Level	Low	Least Expensive	Most Expensive

In short, despite the aforementioned differences in redemption schedules and 12B-1 fee increases, an investor ***choosing only amongst loaded mutual funds*** should consider the following:

- Class-A shares are the best option over a long-term horizon (i.e. fewest cumulative expenses)
- Class-C shares are the best option over a short-term horizon (avoiding the relatively large one-time sales charge)
- Class-B shares are rarely either the best or worst option
- All loaded classes, particularly Class-B and Class-C, have opaque and complicated fee structures

Transparency Issues

Clients are often more aggravated by the opaqueness of hidden fees than fees themselves. With transparency problems come skepticism and distrust. Transparency problems have led to a general distrust of financial markets by the investing public – the implications of this distrust are far-reaching.

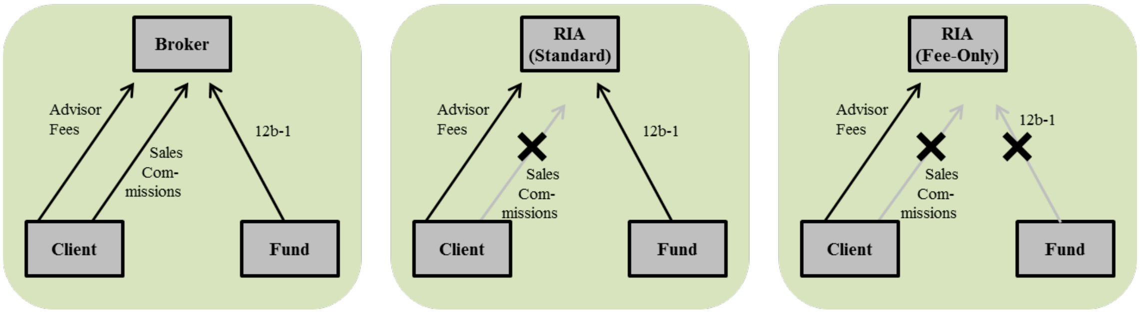
Transparency standards for RIA firms are more stringent than those for brokerage firms. Unlike brokers, RIAs are required to disclose all compensation in their Form ADV filing. This includes advisory fees, commissions and any other form of compensation.

These transparency features improve an investor's ability to objectively evaluate potential conflicts-of-interests in the advisor/client relationship. Yet even with improved transparency, the mere acceptance of commissions can create potential conflicts-of-interests.

To remove this conflict-of-interest, some RIA firms simply do not accept commissions. These RIA firms are known as Pure RIAs or Fee-Only RIAs. Independence Wealth Advisors is a Fee-Only RIA firm.

The exhibit below illustrates the differences in revenue models by which brokers, standard RIAs and fee-only RIAs are compensated:

Compensation Model Comparison: Broker, RIA (Standard) and RIA (Fee-Only)



Empirical Evidence of Broker Investment Performance

One study[5] conducted by Santash Anagol of Wharton concluded that commission-based brokers "cater to customers' pre-conceptions of what the right product is for them as much (if not more) than to objective information about what the right product is." While this finding is insightful, is really is not surprising given the basic incentive structure of the brokerage industry. Commission-based advisors incur opportunity costs when attempting to talk a client out of a bad investment decision.

An Illustration of a Common Broker-Investor Interaction

To illustrate, consider the decision facing a commission-based broker during the dot-com boom of the 1990s. After watching tech stocks achieve extraordinary returns, a client emphatically demands to his broker to sell all assets and buy with the proceeds *only* tech stocks. The broker could either (1) cater to the investor's desire, or (2) recommend a diversified portfolio that more diligently considers market risk factors, as well as the investor's individual goals and constraints. Clearly, the diversified portfolio is the responsible choice.

Example: Client Biases and Broker Incentives			
Option	**Comission**	**Time Spent**	**Odds of Advice Acceptance**
Tech Fund	$10,000	Short	Higher Probability
Diversified Portfolio	$10,000	Long	Lower Probablility

Is it any surprise the advisor caters to the investor's (ill-advised) preference of the tech fund? The time and effort to de-bias an investor can be significant and unsuccessful. Even though the advisor knows the diversified portfolio is the better option, he/she can justify the decision by thinking "The client is going to invest in the tech fund regardless of what I say – either I or my competitor will be $10,000 richer."

Perspective & Concluding Points

In fairness and clarity - statistics describing an entire industry cannot be extrapolated and applied to each individual of that industry. Just because a particular broker is subject to a suitability standard does not make that broker apathetic to client interests. Undoubtedly, there are many commission-based brokers who personally hold themselves to high ethical standards and profoundly care about their clients' interests.

Nonetheless, it is imperative clients understand the legal framework and incentive structures governing the relationship with their financial advisor. It is highly likely any advisor competing for your business will tell a prospective client something to the effect of "I'm on your side" or "I have your best interests at heart." Investors seeking an advisor need a framework with which to evaluate statements such as these. The more objective information a client has, the more likely investors will select the right advisor.

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